Bateleur BCI SA Equity Fund

2023 final report back

bateleur capital

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25 January 2024

Dear Investor

Bateleur BCI SA Equity Fund ("The fund") – 2023 final report back

The fund returned 10.0% (net of fees) for the year ending December 2023, ahead of its benchmark (JSE Capped Shareholder Weighted Index with dividends reinvested) of 7.9%.

Stock selection was sound with AECI, Bidcorp, Bidvest, Hudaco and Shoprite contributing a combined 4.3% in relative performance. Gold miners were the fund's largest detractors, partially offset by limited direct exposure to platinum group metal miners.

A summary of the top contributors and detractors is illustrated in Table 1 below.

Table 1 – Top relative contributors and detractors 2023

Top relative contributors	%	Top relative detractors	%
AECI	1.2%	Goldfields	-0.9%
Bidcorp	0.8%	Sanlam	-0.9%
Bidvest	0.8%	Harmony	-0.6%
Hudaco	0.8%	BHP Group	-0.6%
Shoprite	0.7%	Richemont	-0.5%

Source: Bateleur Capital; Bloomberg, 31 December 2023

Bateleur's longest running SA Long Only Equity strategy maintained its solid track record^, having appreciated by 12.0% CAGR (net of fees) since inception in May 2012, ahead of its benchmark* that returned 10.0% CAGR (gross of fees) over the same period (Chart 1).

The short term track record has been assisted by good returns over the past 3 years, with the fund delivering an 18.0% CAGR over the period. The return compares favourably to both global (measured in rand) and local equity markets (Chart 2).

Chart 1 – Bateleur SA Long Only equity strategy

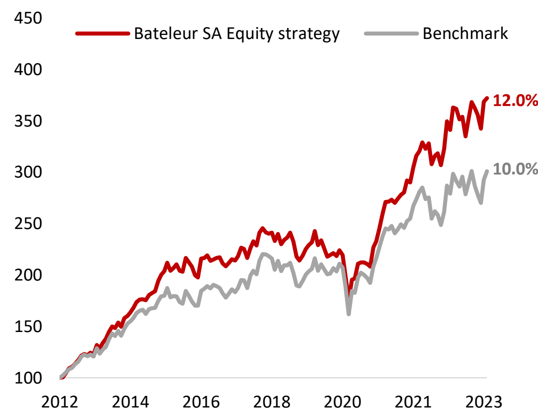
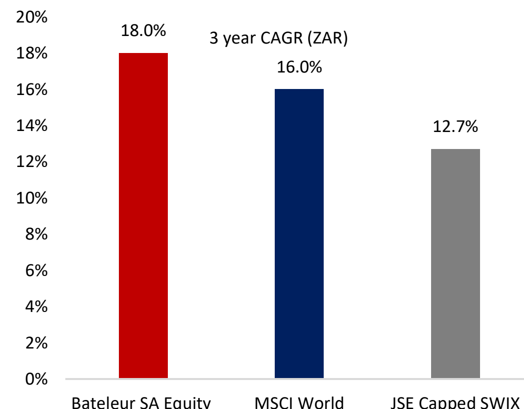


Chart 2 – Short term track record (3yr CAGR)



Source: Bateleur; Bloomberg; ^longest running SA Long Only equity strategy; *SWIX to July 2021 and Capped SWIX from August 2021 onwards
Highest rolling 1 Year Return – Bateleur BCI SA Equity Fund | 54.4%
Lowest rolling 1 Year Return – Bateleur BCI SA Equity Fund | -25.5%

Global equity markets enjoyed a late surge in 2023 with investors calling the end of the US rate hiking cycle after a string of relatively benign inflation readings. Consensus expectations moved to price in a "soft landing" and a shift to lower interest rates in 2024. This goldilocks scenario is expected to deliver slowing inflation and moderate GDP growth accompanied by a stable US labour market.

While such an outcome would be welcomed by capital markets, it is unlikely that it will unfold precisely as anticipated. We expect that the direction of asset prices will continue to be driven by a volatile macroeconomic environment.

Key focus areas for the year include:

Inflation and interest rates

After peaking at 9.1% in June 2022, the latest US CPI reading in December 2023 was 3.4%, and there are ongoing signs of inflation pressures easing. Goods inflation has fallen to a standstill and lead indicators point to limited pressure on supply chains (Charts 3 & 4).

Chart 3 – US CPI (Goods & Services)

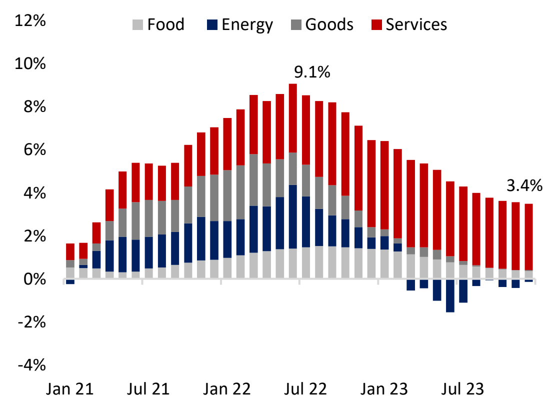
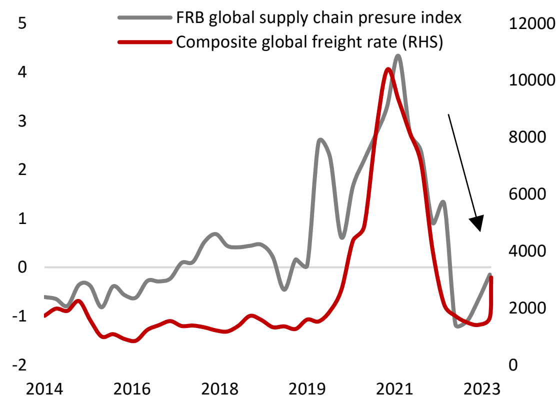


Chart 4 – Lead indicators for goods inflation



Source: Bateleur Capital; Bloomberg, 31 December 2023

Services inflation remains high, but is almost completely being driven by lagging shelter readings (rent of primary residence and owners equivalent rent), which are expected to slow in the year ahead based on softening lead indicators and the high base set during 2023 (Charts 5 & 6).

Chart 5 – US inflation driven by shelter

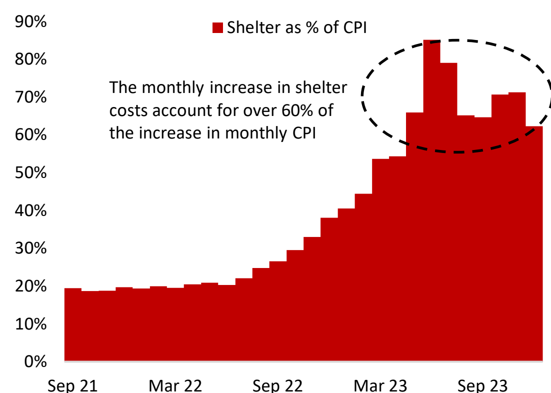
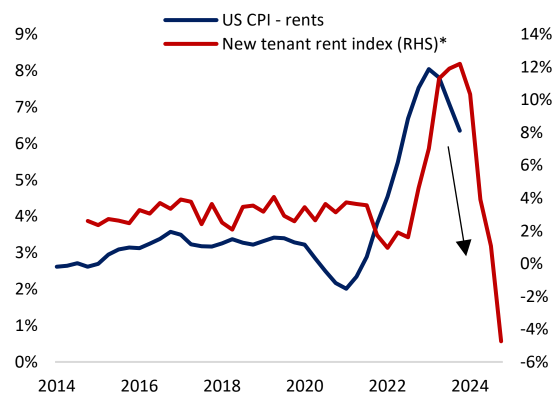


Chart 6 – Lead indicators for shelter softening



Source: Bateleur Capital; Bloomberg, 31 December 2023 *BLS rent lead index – advanced 3 quarters

With goods inflation stable and services cost pressure moderating, headline inflation could be on track to *approach* the Federal Reserve's (Fed) long-term target of 2.0% during 2024. Geopolitics and the current soft oil price remain key risks to this benign outlook.

A Fed funds rate of 5.5% and inflation at 3.4%, implies real rates are approximately 2.0%. This would be considered normal by historical standards, but well above the negative real rates that dominated the last 10 years (Chart 7).

This provides sufficient room for the Fed to begin reducing rates with the most recent Fed projections pointing to 3 cuts, of 0.25% each, over the course of 2024. This is at odds with market expectations, pricing in 6 rate reductions, of a similar quantum, by year end (Chart 8).

Ultimately lower funding rates should be positive for asset prices in the medium term. The trajectory of interest rates, and the expectations of how deep the Fed will cut, are expected to dominate headlines and drive short term capital market volatility.

Chart 7 – US real rates are elevated

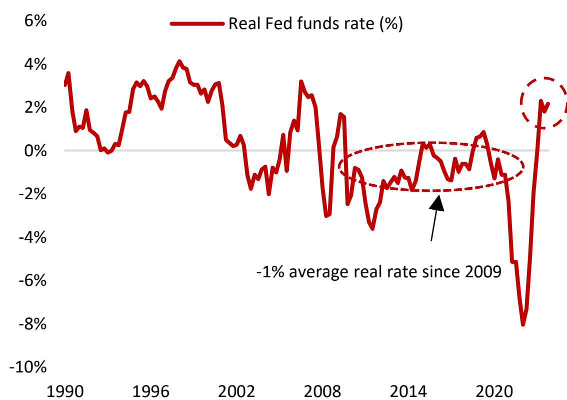
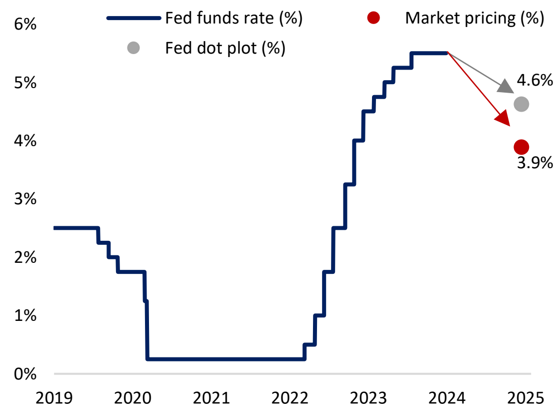


Chart 8 – Fed funds rate expectations



Source: Bateleur Capital; Bloomberg, 31 December 2023

<u>Fading economic tailwinds</u>

Looking forward, GDP growth rates are expected to slow as the impact of past rate hikes filter through the economy, consumer savings deplete and the benefits of US fiscal stimulus annualise from elevated levels.

1) Slow transmission of higher interest rates

The rapid increase in interest rates over the past 18 months would have historically resulted in a cooling of the economy and a probable recession. This was the expectation at the start of 2023.

However, this cycle has been different as households took advantage of the extended period of low rates to lock in favourable mortgage rates and corporates extended loan maturities at an opportune time.

The US Bureau of Economic Analysis (BEA) estimates that the current effective rate on mortgage debt is only 3.7%, while prevailing mortgage rates for new loans sit at 7.0% (Chart 9). Similarly, corporates took the opportunity to restructure debt and extended maturities with nearly half the S&P 500 constituents debt maturing after 2030 (Chart 10).

Though the impact of high interest rates experienced a lag, it will continue to manifest gradually as prevailing loans undergo refinancing and new loans are secured at higher rates than in the recent past.

Chart 9 – Consumers fixed mortgages

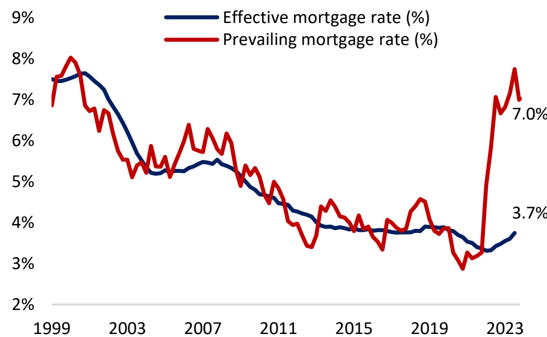
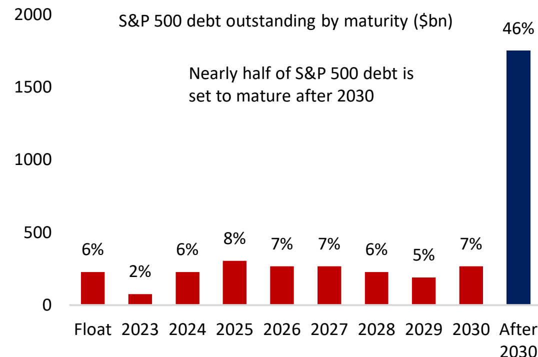


Chart 10 – Corporates lengthened debt maturities



Source: Bateleur Capital; Bloomberg, Goldman Sachs, BEA, 31 December 2023

2) Pandemic excess savings deplete

When the pandemic occurred, household spending dropped as people stayed at home and businesses temporarily shut. At the same time, incomes were bolstered by a significant increase in federal spending in the form of unemployment benefits and stimulus cheques. As a result, the American consumer accumulated trillions of dollars of savings.

These excess savings, defined as savings accumulated when household savings is above trend, peaked during 2021 and have been drawn down to $285bn by November 2023.

The San Francisco Fed estimates consumers are dipping into savings at a rate of $75bn per month, at this pace excess savings should be depleted during the first half of 2024 (Charts 11 & 12).

The tailwinds of pandemic savings are largely done, and will not provide the same level of support to the consumer going forward.

Chart 11 – Savings rates have dropped

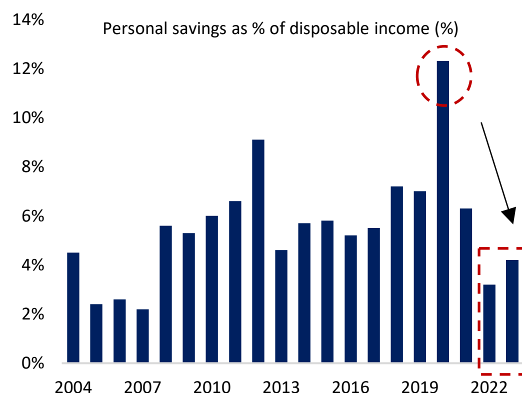
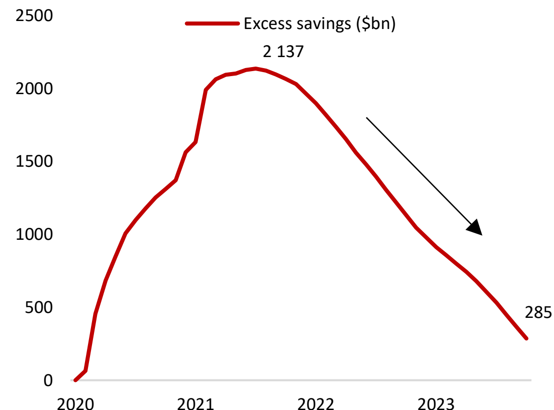


Chart 12 – Excess savings depleted



Source: Bateleur; Bloomberg, 31 December 2023

3) Peak fiscal stimulus benefits

The US has continued to run a large fiscal deficit to support infrastructure investment, job creation and GDP growth with UBS estimating 2023’s $1.7tn budget deficit added almost one percentage

point to GDP (Chart 13). The US is buying growth with substantial deficits that adds to the country's debt burden.

This positive impact will fade into 2024 due to base effects, but more importantly, the longer term sustainability of the US fiscal path is becoming increasingly troublesome versus peers.

Total US federal debt has ballooned to $33tn (122.9% of GDP as at September 2023) and the Congressional Budget Office projections show that treasury will need to issue at least $20tn of new debt to fund growing deficits over the next 10 years.

As rates rise, the interest cost to service these debts has rapidly increased, to almost unaffordable levels, with annualised net interest payments as a percentage of government revenues doubling to over 16% (in 2023), a level last seen during the 1990's (Chart 14).

Chart 13 – US fiscal deficit vs DM peers

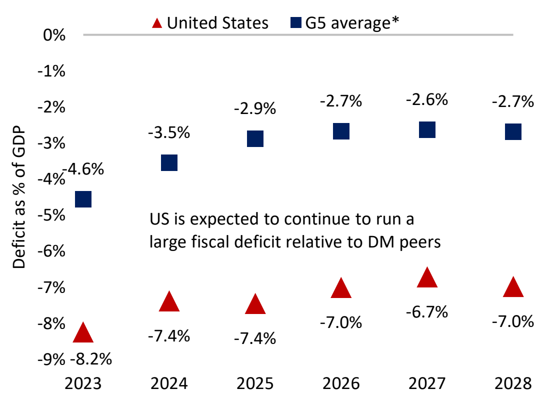
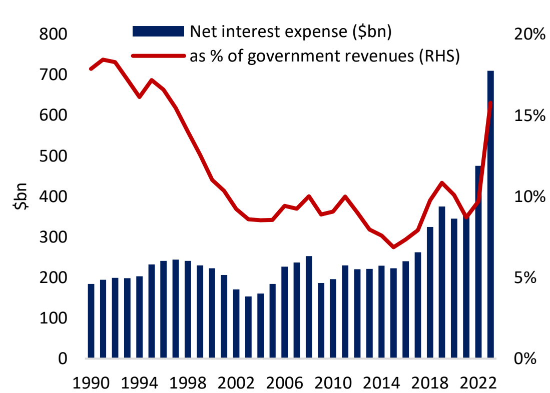


Chart 14 – US interest costs to service debt



Source: Bateleur Capital; Bloomberg, 31 December 2023 CBO *G5 average = average deficit forecast for Germany, Japan, United Kingdom, France and Italy

The ongoing need for fiscal spending will come with future trade offs where the US will have to make hard choices on income (increase taxes) or spending (reduced social security or medical or defence spending), inevitably harming future growth prospects. We view this as a medium term risk for the US economy.

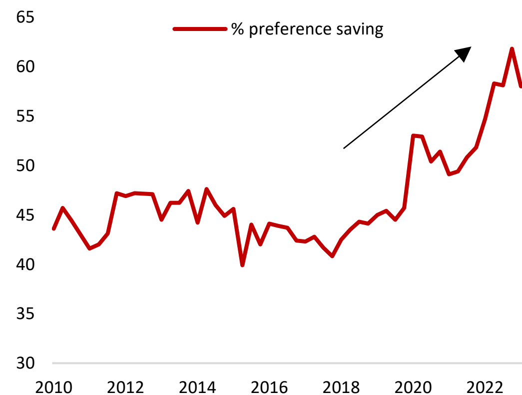
China's economy underwhelms

In stark contrast to the US economy, the Chinese economy continued to underperform expectations in 2023. Asset prices remained under pressure and unlike the US, there has been limited direct support for consumers which has negatively impacted confidence (Chart 15). With the outlook remaining subdued, there is a clear consumer preference for savings over consumption (Chart 16).

Without more forceful monetary and fiscal stimulus, to revive asset price growth, it would seem that the Chinese economy will face similar headwinds in the year ahead - a soft real estate sector, poor consumer and business sentiment and slow consumption growth. Given the well-publicised headwinds facing the Chinese property sector, current activity levels are generally unsupportive of commodity demand.

Chart 15 – China consumer confidence index

Chart 16 – Household intentions survey



Source: Bateleur Capital; Bloomberg, 31 December 2023

In December we travelled to China, Hong Kong and Macau.

We had a very constructive meeting with Tencent's Chief Strategy Officer, James Mitchell, and remain confident in the company's ability to grow earning over the medium term. Tencent is expected to drive further monetisation in advertising, advance profitability in fintech & business services and optimise its domestic and international gaming operations.

Despite promising fundamentals, the share price is being hampered by an uncertain regulatory environment exemplified in late December with the release of a draft paper that could restrict gaming companies' ability to monetise revenues.

While cognisant of the regulatory risk, the fund maintained an overweight position in Naspers/Prosus based on the investment case for Tencent, the steep discount to net asset value and the ongoing accretive share buyback program.

South Africa

Looking ahead there are several global and local themes that will impact the domestic market in 2024, including unforeseen events (like the last couple of years) that fund managers will need to navigate.

We start the year with low expectations (again) due to the constrained macro environment that continues to hold back the inherent potential of the private sector and South Africa as a whole. The interaction of government and business to resolve SOE issues is critical to provide more supportive conditions for business.

Recent forecasts, by prominent financial institutions, point to a marginal improvement in domestic economic activity largely based on better energy availability from Eskom and the ongoing expansion of private electricity generation capacity.

The country's sixth democratic national and provincial elections are expected to take place between May and August with multiple permutations including a potential coalition-led government or another outright win for the current ruling party.

The political landscape has been a driving force behind the multi-year disinvestment of South African bonds and equities by foreign and domestic money managers. However unlikely, a South Africa

governed by more capable and trustworthy individuals in the interest of all citizens will go a long way to halt the outflow of capital.

Global inflation has peaked and is on a path towards normalisation – the pace of which remains uncertain. Given the South African Reserve Bank's generally more conservative approach to monetary policy, we see scope for modest interest rate cuts over the course of the year as developed market central bankers begin to reduce rates from elevated levels.

Fund positioning

There have been no material changes to fund composition during the period.

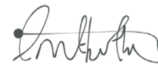
The fund is invested in quality companies which are expected to produce solid earnings growth in the year ahead. We calculate that 49% of the fund's holdings generate revenue in hard currencies and remain tilted towards quality domestic facing companies where valuation multiples are low.

The fund is exposed to China via Prosus/Naspers and a basket of miners (African Rainbow Minerals, Glencore and Anglo American). Resource exposure is lower than in the more recent past given concerns about the Chinese economic recovery.

Conclusion

We are satisfied that the fund produced a solid result in 2023 and look forward to the period ahead.

Kind regards



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The forecasts are based on reasonable assumptions, are not guaranteed to occur and are provided for illustrative purposes only.

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